



The Federal Government's Long-Term Fiscal Outlook

Spring 2012 Update

GAO's Long-Term Fiscal Simulations

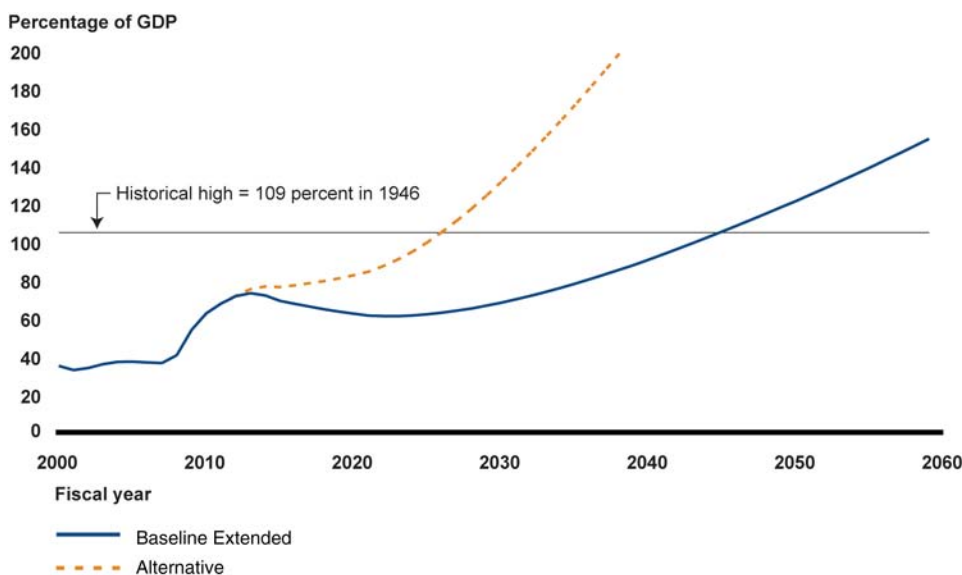
Since 1992, GAO has published long-term fiscal simulations showing federal deficits and debt under different sets of policy assumptions. GAO developed its long-term model in response to a bipartisan request from members of Congress concerned about the long-term effects of fiscal policy. GAO's simulations provide context for consideration of policy options. They are not intended to suggest particular policy choices or to predict the economic impact of any set of choices but to help facilitate a dialogue on this important issue.

GAO regularly updates its simulations as new data become available from the Congressional Budget Office (CBO) and the Social Security and Medicare Trustees (Trustees). This update incorporates CBO's January 2012 budget and economic projections. As in the past, GAO shows two simulations:

The **Baseline Extended** simulation follows CBO's January 2012 baseline, which generally reflects current law, for the first 10 years. The baseline includes the effects from the discretionary spending caps and automatic enforcement procedures put in place by the Budget Control Act (BCA). After the first 10 years, this fiscal constraint is maintained; revenue and spending other than interest on the debt and large entitlement programs (Social Security, Medicare, and Medicaid) are held constant as a share of gross domestic product (GDP). Over the long term, revenue as a share of GDP is higher and discretionary spending lower than historical averages.

Federal deficits and debt have reached historic highs in recent years. Congress has taken action to address the fiscal imbalance, but longer-term challenges remain. The Budget Control Act (BCA) of 2011 limits spending over the next decade and leads to an improved fiscal outlook. The act targets discretionary spending, and under both of GAO's simulations, discretionary spending as a share of the economy would be lower in 2022 than at any point in the last 50 years. Further, as the economy recovers, revenue increases and spending decreases. While the BCA improved the outlook, it did not eliminate the longer-term challenge, in part because it did not focus on the fundamental drivers of the government's future fiscal imbalances—a structural gap between revenues and spending driven by rising health care costs and demographics. As our 2011 simulations showed, if the Patient Protection and Affordable Care Act (PPACA) is implemented as intended it would have a major effect on the gap but would not eliminate it. The aging of the population and rising health care costs will continue putting upward pressure on spending. Assuming revenue in the long term returns to the 40-year historical average and remains stable at that share of GDP, the imbalance between spending and revenues increases, resulting in increasing levels of debt held by the public. A continuing increase in debt as a share of GDP means the federal government is on an unsustainable long-term fiscal path and underscores the need for policymakers to act to change the path. See figure 1.

Figure 1: Debt Held by the Public under Two Fiscal Policy Simulations



Source: GAO.

Note: Data are from GAO's Spring 2012 simulations based on the Trustees' assumptions for Social Security and the Trustees' and the CMS Actuary's assumptions for Medicare.

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In the **Alternative** simulation, expiring tax provisions are extended to 2022 and the alternative minimum tax (AMT) exemption amount is indexed to inflation through 2022. For the first 10 years, discretionary spending reflects the original caps set by the BCA but not the lower caps triggered by the automatic enforcement procedures. Over the long term, discretionary spending and revenue are held at historical averages.

The Baseline Extended simulation follows the Trustees' 2011 intermediate projections for Social Security and Medicare and CBO's June 2011 long-term projections for Medicaid adjusted to reflect excess cost growth consistent with the Trustees' projections. In the Alternative simulation, Medicare spending is based on the Centers for Medicare & Medicaid Services Office of the Actuary's (CMS Actuary) alternative projections that assume reductions in Medicare physician rates do not occur as scheduled under current law and that certain cost-containment mechanisms intended to slow the growth of health care cost are not sustained over the long term. GAO also shows the outlook using CBO's long-term projections for Social Security and the major health entitlements; the results are consistent with GAO's simulations based largely on the Trustees.

Additional information on the fiscal outlook and federal debt is available at www.gao.gov/special.pubs/longterm/.

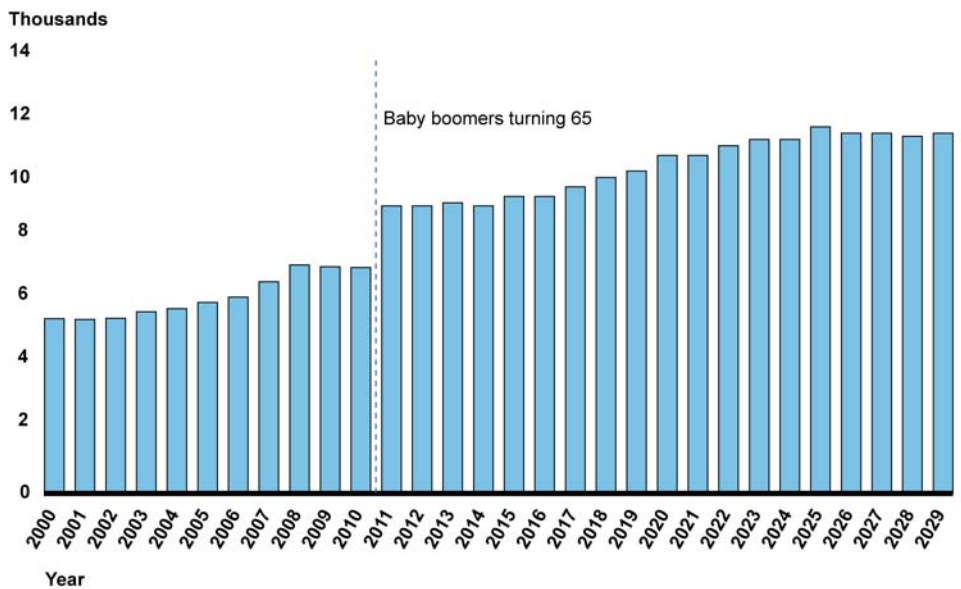
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The pace at which deficits grow and the resulting debt buildup vary depending on the assumptions used: deficits and debt grow less rapidly in the Baseline Extended simulation than under the Alternative simulation, which has both lower revenues and higher spending levels than the Baseline Extended simulation. Under the Baseline Extended simulation, debt held by the public would exceed its post-World War II historical high of 109 percent of GDP by 2048; under the Alternative simulation it would cross this threshold by 2026.

The growing fiscal imbalance is driven on the spending side by rising health care costs and the aging of the population. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare. The Social Security program, which historically ran large cash surpluses that helped reduce the need to borrow from the public to finance other programs, is now projected to pay more in benefits than it receives in tax income each year into the future.¹ Although health care spending growth recently slowed, it has been growing faster than the overall economy and is expected to continue to grow at an increased rate as more members of the baby-boom generation become eligible for federal health programs. As shown in figure 2, the number of baby boomers turning 65 is projected to grow in coming years, averaging about 7,600 per day in 2011, and about 11,400 per day by 2029.

¹Social Security trust fund assets and reserves are used to make up the annual cash deficit. The Trustees project that trust fund reserves will be exhausted by 2036. See the Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Washington, D.C.: May 13, 2011).

Figure 2: Daily Average Number of People Turning 65 Each Year



Source: GAO analysis of U.S. Census Bureau data.

Note: Data are from the U.S. Census Bureau's National Population Projections. For this analysis, we used data from the low net international migration series.

Several provisions of PPACA were designed to control the growth of health care costs. The full implementation and effectiveness of these cost-control provisions, which are reflected in the Baseline Extended simulation, would slow the growth in federal health care spending over the long term. Under the Baseline Extended simulation, spending on Medicare and Medicaid grows from 5 percent of GDP in 2010 to over 7 percent by 2030. There are, however, significant uncertainties surrounding the growth of health care costs. Spending is influenced not only by policies and laws, but also by future demographic and economic trends, development and deployment of medical technology, the cost and availability of insurance, and the responses of health care providers, consumers, and policymakers to these trends. The Trustees, CBO, and the CMS Actuary have expressed concerns about the sustainability of certain health care cost-control measures over the long term. For example, they note that reductions in physician payment rates scheduled to occur under current law have routinely been overridden.

They have also questioned whether a provision in PPACA that would restrain spending growth by reducing the payment rates for certain Medicare services based on productivity gains observed throughout the economy is sustainable over the long term. According to CMS, health care productivity gains have historically been small, and may be difficult

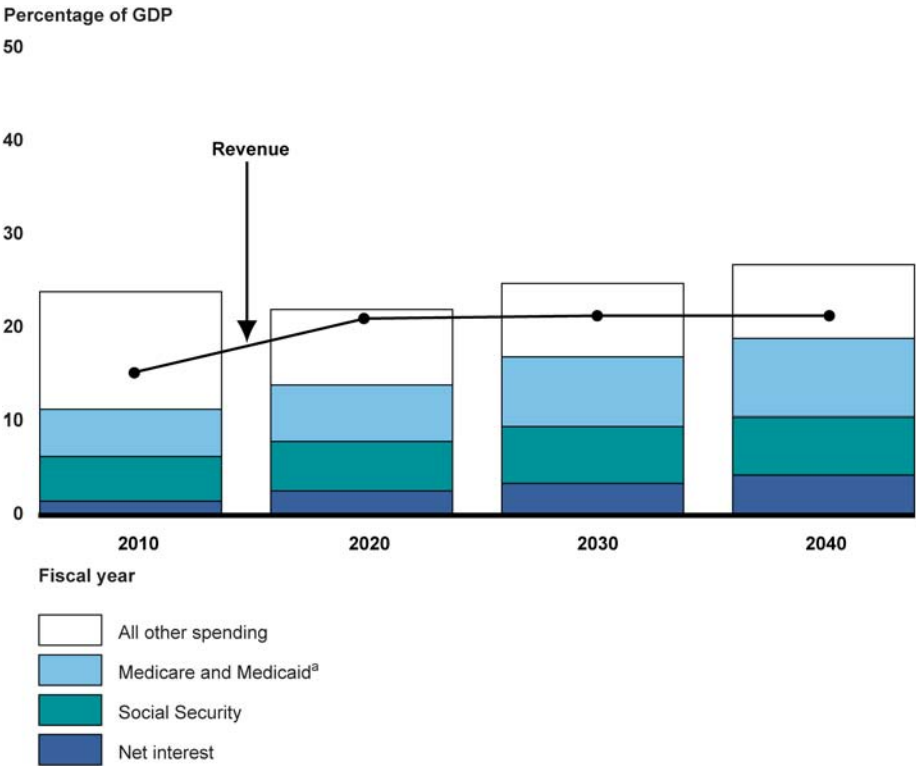
to achieve in the future due to several factors, including the labor-intensive nature of the industry and the individual customization of treatments in many cases. These concerns are reflected in our Alternative simulation, which, consistent with CBO's and the CMS Actuary's alternative scenarios, assumes that certain cost-containment mechanisms are not sustained over the long term.² Spending on health care grows much more rapidly under this more pessimistic set of assumptions. Absent changes to these programs, spending on Medicare and Medicaid under the Alternative simulation grows to over 8 percent of GDP by 2030.

Under either set of assumptions about health care cost growth, spending for the major health and retirement programs will increase, putting greater pressure on the rest of the federal budget. In 2010, about 47 cents of every federal dollar spent went to Social Security, Medicare, Medicaid, and interest on the federal debt. Figures 3 and 4 below show revenue and the composition of spending under the Baseline Extended and Alternative simulations moving forward.

²While both CBO and the CMS Actuary assume that certain cost-containment mechanisms are not sustained, they make different assumptions that affect spending on health care. For example, CBO's assumes that physician payment rates are maintained at 2011 levels. In the CMS Actuary's alternative scenario, physician payment rates grow with inflation (using the Medicare Economic Index), which results in higher spending than under CBO's assumption.

Under the Baseline Extended simulation, revenues as a share of the economy are higher and discretionary spending is lower than historical averages. As figure 3 shows, spending on Social Security, Medicare, Medicaid, and interest would grow to about 70 cents of every dollar spent by 2040. By this time, there is little room for “all other spending,” which includes not only national defense, homeland security, veteran’s health care, and investment in highways and mass transit, but also smaller entitlement programs such as farm price supports and student loans.

Figure 3: Potential Fiscal Outcomes under the Baseline Extended Simulation: Revenues and Composition of Spending



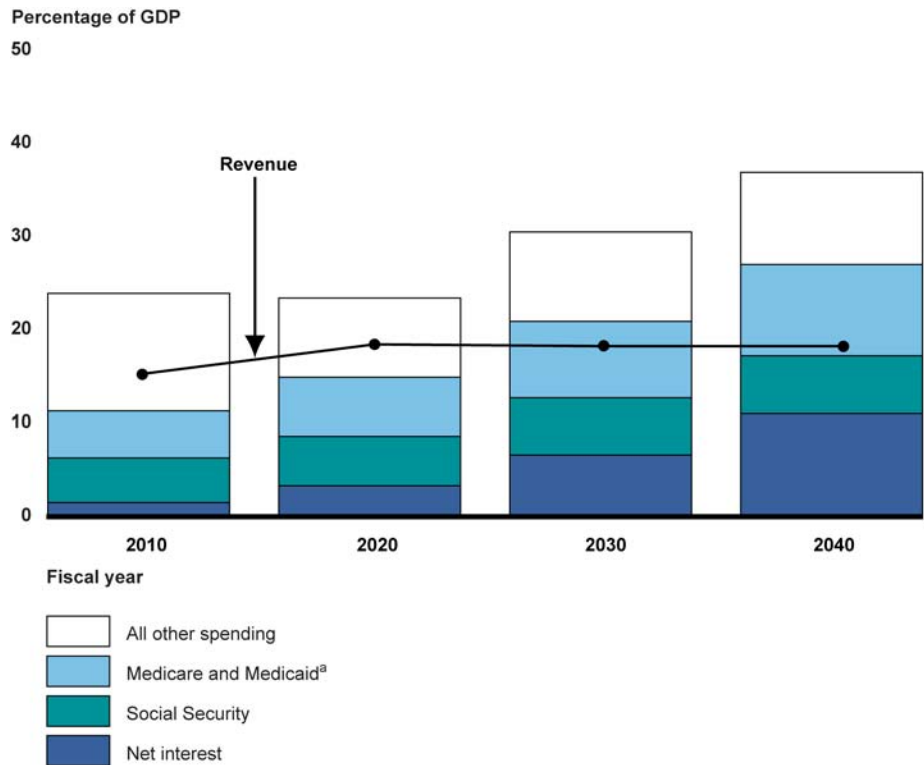
Source: GAO.

Notes: Data are from GAO’s Spring 2012 simulations based on the Trustees’ assumptions for Social Security and the Trustees’ and the CMS Actuary’s assumptions for Medicare.

^aThis also includes spending for insurance exchange subsidies and the Children’s Health Insurance Program.

In the Alternative simulation, revenue and discretionary spending are at their historical averages over the long term. In this simulation, spending on Social Security, Medicare, Medicaid, and interest exceeds revenues by 2030 and by 2040, 73 cents of every federal dollar spent would go to these categories. Overall, our simulations illustrate the difficult trade-offs that policymakers will have to consider in order to rebalance the federal government's fiscal position.

Figure 4: Potential Fiscal Outcomes under the Alternative Simulation: Revenues and Composition of Spending



Source: GAO.

Notes: Data are from GAO's Spring 2012 simulations based on the Trustees' assumptions for Social Security and the Trustees' and the CMS Actuary's assumptions for Medicare.

^aThis also includes spending for insurance exchange subsidies and the Children's Health Insurance Program.

Balancing Near-Term and Long-Term Considerations

When considering action to address the longer-term fiscal challenge, it is important to balance the near-term effects. One tool used to measure the challenge over the long term is the “fiscal gap.” The fiscal gap represents the difference, or gap, between revenue and noninterest spending in present value terms over a certain period, such as 75 years, that would need to be closed in order to achieve a specified debt level (e.g., today’s debt to GDP ratio) at the end of the period. From the fiscal gap, one can calculate the size of action needed—in terms of tax increases, spending reductions, or, more likely, some combination of the two—to close the gap.

For example, under our Alternative simulation, the fiscal gap is 8.2 percent of GDP (see table 1). This means that, on average over the next 75 years, revenue would have to increase by more than 45 percent or noninterest spending would have to be reduced by about 32 percent (or some combination of the two) to keep debt held by the public at the end of the period from exceeding its level at the beginning of 2012 (roughly 68 percent of GDP). Even-more significant changes would be needed to reduce debt to lower levels.

Table 1: Federal Fiscal Gap under GAO’s Simulations

Simulation	Fiscal gap 2012–2086 (percent of GDP)	Average percentage change required to close gap			
		If action is taken today		If action is delayed until 2022	
		Solely through increases in revenue	Solely through decreases in noninterest spending	Solely through increases in revenue	Solely through decreases in noninterest spending
Baseline Extended	1.8	8.4	8.0	9.9	9.4
Alternative	8.2	45.7	32.2	54.3	37.0

Source: GAO.

Note: Data are from GAO’s Spring 2012 simulations based on the Trustees’ assumptions for Social Security and the Trustees’ and CMS Actuary’s assumptions for Medicare.

While immediate action would reduce the size of the changes necessary to close the fiscal gap, the risk to near-term economic growth is also a factor. With this in mind, policy changes could be designed to phase in over time allowing for the economy to fully recover and for people to adjust to the changes. Table 1 illustrates how much greater fiscal policy changes would have to be if no actions were taken for the next decade. Such a delay would increase the risk that the eventual changes will be disruptive and destabilizing. Under our Alternative simulation, waiting 10 years would increase the fiscal gap to nearly 10 percent of GDP—

meaning a revenue increase of about 54 percent or a noninterest spending cut of 37 percent or some combination of the two would be required to bring debt held by the public back to today's level by 2086.

Concluding Observations

The economy continues to recover from the nation's most severe recession since the end of World War II, and while there are calls for continued federal action to support the economy, these must be balanced with the need to act soon to develop a plan for addressing the long-term fiscal imbalance. Absent policy changes, increasingly significant changes will be needed to close the fiscal gap. However, action taken to address the fiscal outlook needs to be balanced with the importance of sustaining economic growth in the near term. If policy changes designed to correct the federal government's fiscal path are too sharp, they could stifle the pace of the recovery in the near term. Conversely, changes in policy designed to encourage near-term recovery could worsen the long-term outlook and increase the size of necessary changes in the long run.

Our simulations show deficits declining over the next several years, but this trend reverses before the decade is over under the assumptions in our simulations. Despite limits on discretionary spending that would bring discretionary spending to levels not seen in recent history, our simulations show total federal spending continuing to exceed revenues and feeding an unsustainable growth in debt. The policy actions required to close the fiscal gap are significant, and changing the long-term outlook will likely require difficult decisions about both federal spending and revenue.

Changes since the Last Update

This update incorporates CBO's January 2012 baseline projections that follow current law at that time.³ A key change from CBO's prior baseline estimates—and our prior long-term fiscal outlook update—was the treatment of deficit reduction related to the BCA. At the time of our last update in fall 2011, it was not known whether lawmakers would enact legislation originating from the Joint Select Committee on Deficit Reduction, and thus whether such legislation or the Budget Control Act's automatic enforcement procedures would be implemented. Therefore, we assumed that deficit reduction resulting from the act would take effect under both the Baseline Extended and the Alternative simulations, but did not make assumptions about the allocation between spending and revenues. Because no such legislation was enacted, CBO's January 2012 baseline reflects the act's automatic procedures—cuts among discretionary, Medicare, and other mandatory spending—that go into effect under current law. Consistent with CBO's baseline, our Baseline Extended simulation also reflects the changes to discretionary and mandatory spending under the automatic enforcement procedures. However, we do not apply the effects of the automatic enforcement procedures to the Alternative simulation in this update. In this regard, our Alternative simulation is consistent with the alternative scenario CBO described in its January 2012 update.

Key Assumptions in Our Federal Simulations

Table 2 lists the key assumptions incorporated in the Baseline Extended and Alternative simulations based on the Trustees' assumptions for Social Security and the Trustees' and CMS Actuary's assumptions for Medicare.

³The CBO report is available at www.cbo.gov. When CBO analyzes the President's budget proposals, usually in March, it also updates its baseline. This year CBO's update includes the effects of the Middle Class Tax Relief and Job Creation Act of 2012 (Pub. L. No. 112-96) that was enacted on February 22, 2012 and extended the payroll tax reduction and emergency unemployment insurance benefits through the end of December 2012 and prevented scheduled cuts in reimbursement rates to physicians. Consistent with past practice, we use the January baseline and so do not include the effects of that legislation. Doing so would have only minimal effect on the longer-term fiscal outlook.

Table 2: Assumptions for Baseline Extended and Alternative Simulations

Model inputs	Baseline Extended simulation	Alternative simulation
Revenue	CBO's January 2012 baseline that assumes tax cuts will expire as scheduled under current law and that an increasing share of taxpayers will be subject to higher tax rates through 2022; thereafter remains constant at 21.0 percent of GDP (CBO's projection in 2022) ^a	CBO's estimates assuming expiring tax provisions other than the temporary Social Security payroll tax reduction are extended through 2022, and the 2011 alternative minimum tax (AMT) exemption amount is indexed to inflation for years 2012–2022; thereafter is phased into the 40-year historical average of 17.9 percent of GDP
Social Security spending	CBO's January 2012 baseline through 2022; thereafter based on 2011 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's January 2012 baseline through 2022 that assumes cuts in physician payment rates will occur as scheduled under current law at the time ^b and that the implementation of the Budget Control Act's automatic enforcement procedures reduces spending; ^c thereafter 2011 Medicare Trustees' intermediate projections	Based on CMS Actuary's alternative scenario that assumes that physician payment rates grow with inflation (using the Medicare Economic Index) ^d in all future years, that spending reductions under the BCA do not occur, and policies that would restrain spending growth are applied fully through 2019 but begin to phase out thereafter
Medicaid, the Children's Health Insurance Program, and exchange subsidies spending	CBO's January 2012 baseline through 2022; thereafter CBO's June 2011 long-term projections adjusted to reflect excess cost growth consistent with the 2011 Medicare Trustees' intermediate projections	CBO's January 2012 baseline through 2022; thereafter CBO's 2011 long-term projections adjusted to reflect excess cost growth consistent with CMS Actuary's alternative scenario and CBO's alternative assumption that a policy that would slow the growth of subsidies for health insurance coverage is not in effect
Other mandatory spending	CBO's January 2012 baseline through 2022, which incorporates the reductions in spending scheduled to occur under the Budget Control Act's automatic enforcement procedures; thereafter remains constant as a share of GDP at 2.3 percent of GDP (implied by CBO's projection in 2022)	Baseline Extended adjusted for extension of certain tax credits and to exclude the effects of the Budget Control Act's automatic enforcement procedures through 2022; thereafter is phased back to 2.3 percent of GDP by 2025 (same as Baseline Extended)
Discretionary spending	CBO's January 2012 baseline through 2022, which reflects the original caps set by the Budget Control Act, as well as the lower caps triggered by the automatic enforcement procedures; thereafter remains constant at 5.6 percent of GDP (CBO's projection in 2022)	Follows the original caps set by the Budget Control Act but not the lower caps triggered by the act's automatic enforcement procedures; after 2022 it gradually phases to 7.5 percent of GDP (the 20-year historical average)

Source: GAO.

Notes: CBO's projections are from *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012) and CBO's 2011 *Long-Term Budget Outlook* (June 2011). Trustees projections are from *The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* and *The 2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, which were both issued on May 13, 2011. Projections from the CMS Actuary are based on *Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers* (May 13, 2011). We assume that Social Security and Medicare benefits are paid in full regardless of the amounts available in the trust funds.

^aBoth simulations assume that the temporary Social Security payroll tax reduction would expire at the end of February 2012. However, the Middle Class Tax Relief and Job Creation Act of 2012 (Pub. L. No. 112-96) extended the reduction through the end of December 2012. The act did not offset the cost of the extended reduction, but we expect that the change would have a minimal effect on the overall outlook.

^bThe Middle Class Tax Relief and Job Creation Act prevented scheduled cuts in reimbursement rates to physicians for 2012 that were assumed to occur under CBO's January 2012 baseline projections. We did not incorporate the effects of this override into the Baseline Extended simulation. Because the act included provisions to offset the costs of the extension, it would have a minimal effect on the longer-term fiscal outlook.

^cThe Budget Control Act established limits on discretionary budget authority for 2013 through 2021. In addition, it specified additional limits on discretionary spending and automatic reductions in mandatory spending, including Medicare, that would take effect if lawmakers did not enact legislation originating from the Joint Select Committee on Deficit Reduction that would reduce projected deficits by at least \$1.2 trillion. Because no such legislation was enacted, those procedures are now scheduled to go into effect.

^dSince 2003, Congress took a series of legislative actions to prevent scheduled reductions in physician payment rates that would otherwise occur under law. Physician fee updates set by Congress have averaged 0.9 percent per year over this period. Growth in the Medicare Economic Index is projected to average 1.9 percent from 2012 to 2020. Thus, the assumption used by CMS, and in our Alternative simulation, implies physician payment rates will grow almost two times faster than they have since 2003.

Table 3 shows the key economic assumptions that underlie all of our simulations. GDP is held constant across simulations and does not respond to changes in fiscal policy. Also, the implied interest rate on federal debt held by the public in our simulations is held constant over the long term even when deficits climb. With large budget deficits, there could be a rise in the rate of interest and a more rapid increase in federal interest payments than our simulations display.

Table 3: Key Economic Assumptions Underlying All of GAO's Long-Term Federal Simulations

Model inputs	All simulations
Real GDP Growth	CBO's January 2012 baseline through 2022; thereafter averages 2.1 percent based on the intermediate assumptions of the 2011 Social Security and Medicare Trustees reports
Inflation (percentage change in GDP price index)	CBO's January 2012 baseline through 2022; 2.0 percent thereafter (CBO's projection in 2022)
Interest rate (on publicly held debt)	Rate implied by CBO's January 2012 baseline net interest payment projections through 2022; phasing to 5.2 percent in 2025 and then constant thereafter (CBO's June 2011 long-term projection)

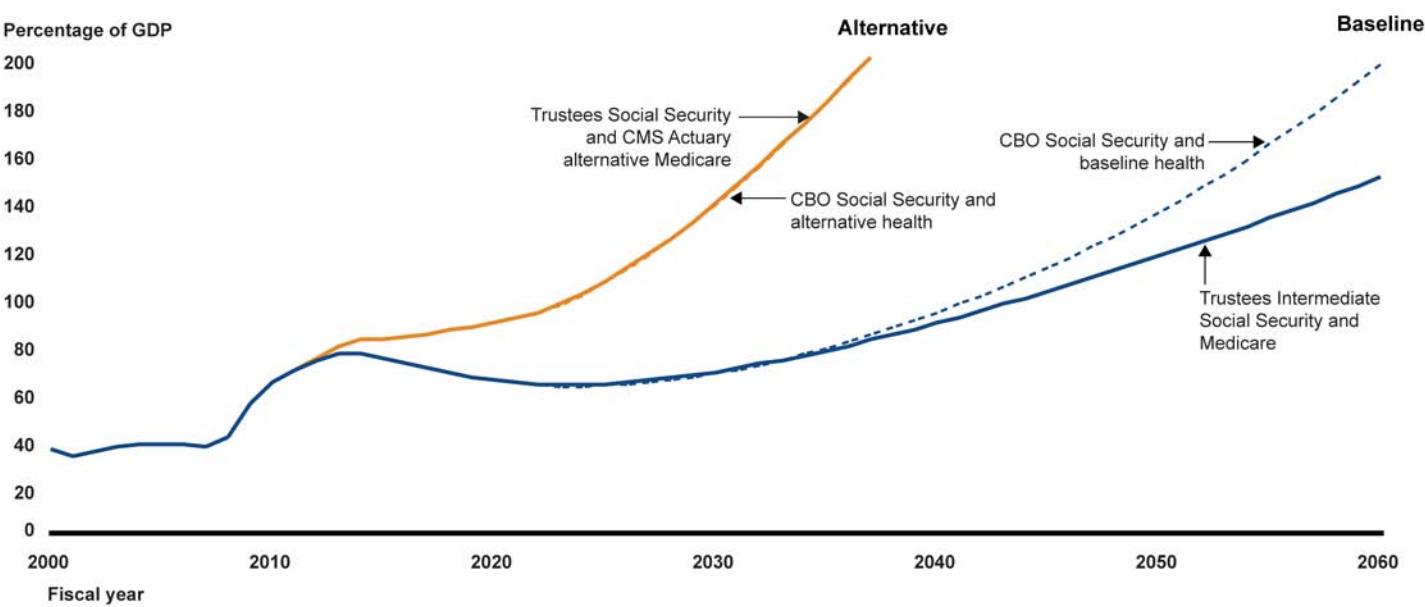
Source: GAO.

A more detailed description of the federal model and key assumptions can be found at www.gao.gov/special.pubs/longterm/fed/aboutlongterm.html.

The simulation results depend largely on what is assumed about growth in large entitlement programs. As in previous updates, we also show the Baseline Extended simulation using CBO estimates for long-term spending on Social Security and major health entitlement programs

(Medicare, Medicaid, and others). In addition, we show the Alternative simulation using different assumptions about certain health care cost-containment provisions based on CBO alternative projections. As figure 5 shows, the results are similar to our simulations using the Trustees and CMS Actuary's projections.

Figure 5: Debt Held by the Public under Fiscal Policy Simulations with Different Assumptions for Major Entitlement Programs



Source: GAO.
Note: The two Alternative simulations are so close that their separate lines are not visible on this graph.

Table 4 shows the CBO assumptions incorporated into the simulations that were used in the comparison shown in figure 5.

Table 4: Key Assumptions Underlying GAO's Simulations Using CBO's Spending Projections for Major Entitlement Programs

Model inputs	Baseline Extended simulation	Alternative simulation
Social Security spending	CBO's January 2012 baseline through 2022; thereafter based on CBO's June 2011 long-term projections for Social Security	Same as Baseline Extended
Medicare spending	CBO's January 2012 baseline through 2022; thereafter based on CBO's June 2011 long-term projections under its extended-baseline scenario	Based on CBO's projections under its alternative fiscal scenario that assume physician payment rates are maintained at 2011 levels through 2022 and that policies to restrain growth are not in effect after 2021 ¹
Medicaid, the Children's Health Insurance Program, and exchange subsidies spending	CBO's January 2012 baseline through 2022; thereafter based on CBO's June 2011 long-term projections under its extended-baseline scenario	CBO's January 2012 baseline through 2022; thereafter CBO's June 2011 projections under its alternative fiscal scenario in which a policy that would slow the growth of per-participant subsidies for health insurance coverage is assumed not to be in effect and eligibility thresholds are assumed to be modified to maintain the share of the population eligible for subsidies

Source: GAO.

Notes: CBO's projections are from *CBO's 2011 Long-Term Budget Outlook* (June 2011). CBO assumes that full benefits are paid regardless of the amounts available in the trust funds.

This product is part of a body of work on federal debt and the long-term fiscal challenge. Related products can be found at www.gao.gov/special.pubs/longterm/past/.

We conducted our work from January 2012 to April 2012 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

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